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SENSITIVE

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TREASURY FOR SUSAN CHUN
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SUBJECT: SRI LANKA: Economic update June 2009

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¶1. (SBU) Summary: Sri Lanka's GDP grew by 1.5% in the first quarter of 2009. Key macroeconomic indicators have also improved. Inflation has slowed to 3.3% in May 2009 from a peak of 28% in June 2008. The trade deficit narrowed as imports continued to fall at a faster pace than exports. Top foreign exchange earners, apparel and remittances are holding steady despite the global crisis. The Colombo Stock Exchange is up 56% in 2009. While foreign exchange reserves are still low, the Central Bank reports it has managed to increase reserves. Nevertheless, the government's fiscal performance, and its ability to keep expenditures under control, remain a serious concern. End Summary.

FIRST QUARTER GDP GROWTH: 1.5%

¶2. (U) According to the Department of Census and Statistics, Sri Lanka's economy expanded by 1.5% in the first quarter of 2009, against 6.2% in the first quarter of 2008. Agriculture grew by 3% compared with 5.9% growth in 2008. Tea, the key agricultural export, recorded a sharp decline due to a drought in February. Excluding tea, agriculture grew by a strong 7%. Rice production increased by 10% and was the main contributor to agriculture growth. Good rains, higher prices, increased production in the eastern province, as well as the government's ongoing subsidized fertilizer program, helped the rice sector. Industry and services growth slowed significantly to 1.9% and 1%, respectively, from over 6% in the first quarter of 2008. Import trade, hotels, ports and the aviation sector contracted sharply by over 10% each, reflecting the direct impact of the global recession. The construction industry recorded 3% growth.

¶3. (U) Despite the 1.5% growth figure, the Central Bank (CB) is now upbeat about economic performance in the second half of 2009 due to the conclusion of the war. In media interviews, the Central Bank Governor indicated plans to revise upwards its current growth forecast of 2.5% for 2009. The governor said that when the CB made earlier forecasts it did not quite know "where the economy was going." However, the CB now believes that reconstruction, agriculture and fisheries in the north and east are likely to be key drivers of expected additional growth in the post-war economy. To help boost growth, the government is starting to undertake various programs. For example, the government recently relaxed restrictions on fisheries in the north and east which it hopes will immediately improve the sector in these regions. The government plans to embark

on a worldwide advertising campaign to promot tourism, aiming to increase arrivals by 20% annally in coming years. (Note: Post believes that tourism is unlikely to experience a large peace dividend immediately, given the global recession.) Tourist arrivals decreased sharply to 438,000 in 2008.

TRADE DEFICIT NARROWS

14. (U) In the first quarter, Sri Lanka's trade deficit contracted sharply to \$645 million from \$1,400 million in 2008. Exports contracted by 12.6%, while imports contracted sharply by 30%. All categories of imports contracted. The oil import bill halved to \$362 million from \$732 million in 2008.

15. (U) On the export side, garment exports recorded a healthy increase of 6%. All other key exports declined. Garment exports to the United States, Sri Lanka's second-largest market, recorded a 4% decline. Exports to the EU, which enter duty free under the EU's GSP-Plus program, increased 21%. Tea, Sri Lanka's second largest export, recorded a sharp downturn in the first quarter. Production fell by 42%. Prices also fell quite sharply during this period. While production continues to be low due to erratic weather, tea prices rebounded by June from the slump experienced since October 2008. The rise in prices is attributed to a shortfall in world tea crops. Consequently, tea prices are expected to remain strong through 2009. One industry leader told EconOff that although production was down 30% in early months of the year, prices are now up 20%. As a result, the industry is hopeful that it will still be able to reach USD one billion in export sales in 2009, as it did in 2007 and 2008.

REMITTANCES

16. (U) Despite the global crises, remittances, Sri Lanka's second largest source of foreign exchange after garment exports, dropped only marginally by 1.7% in the first quarter of 2009 compared to the first quarter of 2008. Total private remittance inflows were \$2.9 billion in 2008.

INFLATION AT 3.3%

17. (U) Inflation, as measured by the Colombo Consumer Price Index (CCPI), rose to 3.3% (year-on-year) in May after having fallen for seven straight months to a low of 2.9% in April. Annual average inflation, however, continued to decline to 14.7% by the end of May, down from 16.7% in April. The Central Bank forecasts inflation will remain at single-digit levels in 2009 and 2010. The relaxation of monetary policy by the Central Bank will affect inflationary expectations. Furthermore, the expected recovery of the economy and relatively higher commodity prices will begin to affect price levels in the second half of the year.

18. (U) On June 15, the Central Bank eased interest rates for the third time in 2009. The bank said in a press release "The prevailing benign inflation environment has enabled the Central Bank to pursue a policy path that is more supportive of economic activity during 2009." The Central Bank lowered its benchmark repurchase rate by 50 basis points to 8.5%. The reverse repurchase rate (at which it lends to banks) was also lowered by 50 basis points to 11%. The bank hopes lower rates will spur economic activity and support reconstruction and development work in the newly-liberated areas. The government's earlier moves to reduce interest rates have not been successful, as private sector credit contracted in the past few months.

19. (SBU) Government fiscal performance will remain a key concern in 2009. According to Finance Ministry sources, state revenue is now estimated to fall sharply by over 1.3% of GDP in 2009 due to a fall in imports and slowdown in economic activity. Consequently, the government is running a high overdraft from state banks. Meanwhile, government expenditures have increased. The Finance Ministry is planning to request additional funds from the parliament through supplementary estimates in coming weeks to meet additional expenditure. The government's original budget forecast anticipated a deficit of 6.5% of GDP; however, analysts agree that such a forecast was unrealistic in the current global economy.

RUPEE IS STEADY ADMIST HOPES OF IMF FUNDS

¶10. (U) The Sri Lankan Rupee depreciated against the U.S. dollar in early May to about Rs 120/\$1, after the Central Bank stopped intervening in the market. It has appreciated by about 4% since then to about Rs 114.90/\$1. According to banking sources, the appreciation would have been higher if not for state banks buying at the above rate. The rupee has strengthened on the hope that a loan from the IMF will soon be approved. The demand for foreign exchange is low at present. The government in response has relaxed foreign exchange controls imposed in the wake of low reserves in 2008. It has removed deposit requirements on imports as well.

¶11. (U) The Central Bank reported an increase in foreign reserves in June due to an inflow of foreign funds to government bond markets after the end of the war. Reserves have increased by about \$300 million in the past few weeks. According to latest published data, gross official reserves were \$1.2 billion, equivalent to 1.2 months of imports, by end of March. Total foreign reserves were reported at \$2.7 billion, sufficient to finance 2.5 months of imports.

STOCK MARKET IS UP 52% IN 2009

¶12. (U) The Colombo Stock Exchange (CSE) has partially recovered from the slump experienced in 2007/2008. It is up 23% since the conclusion of the war in mid-May, taking its total gains in 2009 to 56%. As of June 17, CSE's All Share Price Index (ASPI) stood at 2342 points. Nonetheless, it has yet to fully recover the losses recorded in 2007-2008 due to the escalation of violence in Sri Lanka. ASPI recorded its highest level at 3016 points in February 2007, before the LTTE air attacks in Colombo.

¶13. (SBU) COMMENT: The fall in state revenue, and the increase in expenditures, leads post to believe the GSL -- despite private and public rhetoric that it has and will meet all IMF conditions -- continues to be unable to adequately manage its accounts. The government must identify and quickly implement concrete measures to increase revenue collection and decrease overall spending, or risk greater financial difficulties later in the year.

MOORE